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In the Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether "ceding commissions" payable by a reinsurer to the initial insurer as consideration for the right to share in the future income stream from a block of life insurance policies reinsured under contracts of indemnity reinsurance are fully deductible in the year paid, or, instead, whether such payments must be capitalized and amortized over the estimated life of the reinsurance agreements.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-9a) is reported at 843 F.2d 201. The opinion of the Tax Court (Pet. App. 11a-22a) is unofficially reported at 51 T.C.M. (CCH) 1123.

JURISDICTION

The judgment of the court of appeals was entered on April 26, 1988. A petition for rehearing was denied on May 25, 1988 (Pet. App. 23a). The petition for a writ of certiorari was filed on August 22, 1988. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Sections 809 and 818 of the Internal Revenue Code of 1954 (26 U.S.C.) and Section 1.809-4 of the Treasury

Regulations on Income Tax (26 C.F.R.), as in effect for 1975 and 1976, are set forth in pertinent part in a statutory appendix (App., *infra,* 1a-3a).

STATEMENT

1. Petitioner is a Louisiana corporation engaged in the business of writing and reinsuring life, accident, and health insurance contracts. During the years at issue, it qualified for federal income taxation as a "life insurance company" under Section 801 of the Internal Revenue Code.[1] In 1975 and 1976, petitioner entered into four indemnity reinsurance agreements with respect to a block of life insurance policies written by Transport Life Insurance Company. In these agreements, petitioner agreed to reinsure the aggregate total of 76.6% of Transport's liabilities under that block of policies by indemnifying Transport for that portion of its losses.[2] Some of the reinsurance was accomplished by means of conventional coinsurance agreements, while the bulk of the reinsurance was ac-

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect in 1975 and 1976, the years at issue (the Code or I.R.C.).

[2] In indemnity reinsurance of the types involved here, the initial insurer and the reinsurer agree to share the premiums, expenses, and liabilities on a block of existing policies. The reinsurer in "indemnity reinsurance" does not become directly liable to policyholders, but agrees only to indemnify the initial insurer for its losses; the initial insurer continues to receive premiums and to pay expenses and benefits to the policyholders. This method of reinsurance contrasts with "assumption reinsurance," in which the reinsurer, in effect, steps into the shoes of the issuing company with respect to the policies, becoming directly liable to the policyholders and directly entitled to premium payments made by them. See generally Pet. App. 2a-4a; *Modern American Life Ins.* v. *Commissioner,* 830 F.2d 110, 110 n.2 (8th Cir. 1987).

complished by means of modified coinsurance agreements.[3] Under both forms of reinsurance, petitioner became entitled to 76.6% of the future premiums (less expenses) received on the policies. Pet. App. 2a, 4a-5a. Transport had the right to reacquire portions of the ceded business at scheduled intervals (*id.* at 6a).

The agreements provided that Transport was to pay "reinsurance premiums" to petitioner equal to the amount of the reserves required to be established by petitioner to cover the conventional coinsurance liability for this block of policies.[4] These reinsurance premiums were $675,762 for the 1975 agreements, and $851,398 for the 1976 agreements. The agreements separately provided that petitioner was to pay "ceding commissions" to Transport of $680,000 for the 1975 agreements and $852,000 for the 1976

[3] Under the "conventional coinsurance" agreements, which covered 6.6% of the policies, petitioner established its own reserves to cover the reinsured liability and Transport reduced its reserves accordingly. Under the "modified coinsurance" agreements, covering 70% of the policies, Transport continued to maintain the required reserves and was required to collect and pay over to petitioner the investment income derived from the assets supporting those reserves.

[4] Initial reinsurance premiums were provided for only in the conventional coinsurance agreements (covering 6.6% of the block). There were no reinsurance premiums called for in the modified coinsurance agreements (covering 70% of Transport's rights and liabilities on the block), because Transport retained all assets corresponding to the reserve liabilities reinsured under those agreements. The combined effect of the conventional and modified coinsurance agreements was simply to allow a netting of payments so that virtually no cash changed hands. See Tr. 35. The parties, however, elected to have the modified coinsurance transactions treated for tax purposes as if they were conventional coinsurance agreements (see Section 820 of the Code (repealed in 1984)). Therefore, petitioner was treated for tax purposes as having received reinsurance premiums under those agreements also, in the amount of the reserve liabilities attributable to the reinsured risks. See Pet. App. 6a.

agreements, in consideration for the future premium income acquired. These offsetting obligations were netted against each other before payment, with the result that petitioner paid Transport $4,238 in 1975 and $602 in 1976. In addition, petitioner paid a finder's fee of $13,600 in 1975. Pet. App. 4a-5a.

On its federal income tax returns for 1975 and 1976, petitioner sought to deduct the full amount of the "ceding commissions," as well as the finder's fee, in the years of payment. Thus, petitioner reported tax losses of $693,600 for 1975 and $852,000 for 1976 as a result of the reinsurance transactions, although petitioner had entered into those transactions fully expecting that they would be profitable.[5] The Commissioner disallowed the deductions claimed for the ceding commissions and finder's fee. The Commissioner determined that these amounts represented the acquisition costs for economic benefits having a useful life beyond the year of payment—namely, the right to petitioner's share of the future income stream earned from the reinsured policies. Accordingly, the Commissioner concluded that the ceding commissions should be capitalized and amortized over the period of indemnification (which was later stipulated to be seven years (Pet. App. 9a n.6)). *Id.* at 2a, 6a, 16a.

2. Petitioner filed a petition in the Tax Court seeking redetermination of the resulting deficiencies, and the Tax Court ruled in its favor (Pet. App. 11a-22a). Relying on its prior decision in *Beneficial Life Ins. Co.* v. *Commissioner*, 79 T.C. 627 (1982), the court held that ceding commissions

[5] The other aspects of the reinsurance transactions generated no taxable gain or loss to petitioner. The reinsurance premiums received by petitioner from Transport were reported as income, but those amounts were exactly offset by deductions allowed for the concomitant increase in petitioner's reserve liabilities for the reinsured policies. Pet. App. 6a.

paid to the reinsured company in indemnity reinsurance transactions may be deducted in full in the year of payment (Pet. App. 16a-22a). The court viewed an indemnity reinsurance transaction not as a sale of intangible assets, but as the initial insurer's purchase of insurance from the reinsuring company. On that view, the court reasoned, petitioner could reduce its income by the amount of the ceding commissions under the Code's allowance for "return premiums, and premiums and other consideration arising out of reinsurance ceded" (see Section 809(c)(1)).[6] Pet. App. 17a-18a. The Tax Court acknowledged that ceding commissions paid in connection with an assumption reinsurance transaction would have to be capitalized and amortized over the estimated life of the policies involved, but it justified this apparent inconsistency as being required by the Code itself on the ground that the Code "treats an assumption reinsurance transaction as a sale by the initial insurer to the reinsuring company" (*id.* at 17a).

3. The court of appeals reversed (Pet. App. 1a-9a). Agreeing with the Eighth Circuit's decisions in *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110 (1987), and *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222 (1987), the court held that the ceding commissions reflected petitioner's acquisition costs for the intangible right to future income obtained under the indemnity reinsurance agreements, and therefore were not fully deductible in the year of payment. The court found con-

[6] The provisions of the Code pertaining to the taxation of life insurance companies were substantially revised by Section 211 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 720. Section 809(c)(1) is carried forward in the revised provisions in substantially the same form in Section 803(a)(1) and (b) of the amended Code, which applies to tax years beginning after December 31, 1983. The question presented in this case was not addressed by Congress in the revision and does not appear to have been affected.

trolling the "fundamental rule that an amount expended to acquire an asset or economic interest, benefit or advantage with an income producing life extending substantially beyond the current taxable year may not be [expensed] in the year of payment but must be depreciated or amortized over its useful life" (*id.* at 7a-8a). Applying that rule to the transactions here, the court concluded, required that the ceding commissions be amortized over the useful life of the policies (*ibid.*).

The court of appeals specifically rejected the Tax Court's view that indemnity reinsurance should be treated differently from assumption reinsurance with respect to ceding commissions (*id.* at 9a). In particular, the court criticized the view that indemnity reinsurance is more analogous to the issuance of new insurance, in which underwriting expenses are currently deductible. The court found its earlier analysis in the assumption reinsurance context to be equally applicable here, concluding that the ceding commission " 'in no way represents the cost of putting the business on the books of the company. It represents instead, an estimate of the current value to the taxpayer that is represented by having these policies on its books with the expectation of the continuing premiums to be paid in the future.' " Pet. App. 9a (quoting *Southwestern Life Ins. Co.* v. *United States*, 560 F.2d 627, 640-641 (5th Cir. 1977), cert. denied, 435 U.S. 995 (1978)). The court also determined that neither Section 809(c)(1) nor any other section of the Code overrode the basic capitalization rules that otherwise control this case and that require amortization of ceding commissions (Pet. App. 8a).[7]

[7] The court of appeals further held that the $13,600 finder's fee must also be capitalized and amortized over the life of the policies (Pet. App. 9a). The Tax Court had upheld the immediate deduction of the finder's fee, mistakenly stating that the Commissioner had conceded that the finder's fee should be currently deductible if the ceding commissions were held to be currently deductible (*id.* at 22a).

SUMMARY OF ARGUMENT

The ceding commissions paid by petitioner represent its acquisition costs for an intangible asset—namely, a future income stream generated by the reinsured policies. Any other taxpayer, in any other setting, would have to capitalize that expense as the acquisition cost of an intangible asset or interest with an income-producing life extending substantially beyond the current tax year, and would have to amortize that cost over the appropriate period. The same result is also required in this case.

1. Indemnity reinsuance of the sort involved here is a vehicle by which one insurance company shifts some of the risks on policies it has written to another insurance company—the reinsurer. In that transaction, the reinsured company gives up a share of the future income from all or part of a block of policies, and the reinsurer agrees to indemnify the reinsured company for the same percentage of losses incurred on the block. To acquire that future income, the reinsurer pays the initial insurer an up-front "ceding commission." Under long established tax principles, that acquisition cost must be capitalized and amortized over the indemnification period.

It is undisputed that ceding commissions payable by a reinsurer to a reinsured company in the case of *assumption* reinsurance must be capitalized as the cost of acquiring intangible assets. The same result should follow here. Indemnity reinsurance differs in some respects from assumption reinsurance, but none of those distinctions is germane to the tax treatment of ceding commissions. The pivotal fact that is common to both is that the reinsurer makes a payment to acquire the right to a future stream of

income from the reinsured policies. The purpose of paying up-front ceding commissions in either case, quite simply, is to purchase that profitable right.

Permitting a current deduction of ceding commissions would grossly distort petitioner's income by mismatching the income to be derived from the reinsured policies over future years and the current costs of acquiring that income. There is no reason to believe that Congress intended to permit indemnity reinsurers to distort their income in this way, which would drastically depart from basic tax principles applicable to all other taxpayers (including assumption reinsurers) who make current expenditures for future benefits.

2. The specific provisions of the Code that govern life insurance companies in no way override the basic rules of capitalization and amortization of acquisition expenses as applied to ceding commissions. Contrary to petitioner's argument, Section 809(c)(1), which allows the subtraction from "gross premiums" of "return premiums, and premiums and other consideration arising out of reinsurance ceded," does not permit the immediate deduction of the ceding commissions here. When read in context, it is apparent that Section 809(c)(1) was designed only to ascertain an insurance company's true premium income. It does this by allowing appropriate adjustments to gross premium receipts for amounts that ultimately do not "belong" to the company that receives them, but instead must be returned to the policyholder or paid over to another company. Section 809(c)(1) therefore does not apply to ceding commissions, which are paid for the right to share in the ceding company's future premium income.

Ceding commissions are not "return premiums" within the meaning of Section 809(c)(1) or its associated regulation. A ceding commission is paid contemporaneously

with the closing of the reinsurance transaction, and there is no sense in which this up-front capital outlay is being "returned" to the ceding company. Nor are ceding commissions "consideration arising out of reinsurance ceded." That branch of Section 809(c)(1) permits only the *ceding company* to deduct from its gross premiums amounts it pays to a reinsurer to obtain indemnity reinsurance. The subtraction of ceding commissions from gross premiums that petitioner seeks is thus incompatible with the language and purposes of Section 809(c)(1).

3. Petitioner is also wrong in arguing that Congress intended ceding commissions to be deductible under Section 809(d)(12) as "ordinary and necessary" expenses, just as agent's commissions are currently deductible upon the sale of a single insurance policy. Section 809(d)(12) of the Act embraces only the usual range of "ordinary and necessary" deductions, and that provision in no way comprehends the capital payments embodied in a ceding commission. A ceding commission has no kinship to an agent's commission, other than the colloquial designation of both as "commissions." A ceding commission does not compensate anyone for personal services in selling a policy, but is paid for the right to share in future income from an intangible asset—a block composed of thousands, perhaps hundreds of thousands, of insurance policies. Indeed, the ceding commission is paid not to an agent or employee, but to the ceding company, which stands in the place of the policyholder in its relationship to the reinsurer.

4. Section 818(a) of the Act also affords no grounds for deduction of the ceding commissions. That provision specifies that federal income tax computations for life insurance companies shall be consistent with those prescribed for annual statement purposes by the National Association of Insurance Commissioners (NAIC), *except* when the rules of accrual accounting dictate a contrary

result. This exception is directly applicable here because accrual accounting mandates the amortization of the acquisition costs of a capital asset.

ARGUMENT

I. FUNDAMENTAL PRINCIPLES OF TAXATION REQUIRE CAPITALIZATION AND AMORTIZATION OF CEDING COMMISSIONS

Reinsurance transactions like the ones involved here are commonly employed in the life insurance industry, and they serve useful purposes for both the initial insurer and the reinsurer. From the initial insurer's perspective, reinsurance reduces or eliminates the risk associated with a block of policies it has issued by passing on part or all of the initial insurer's liability to the reinsurer. Reinsurance can also serve a financing purpose for the initial insurer by reducing the drain on its surplus from the expenses of writing new policies (see Pet. App. 2a n.2). From the reinsurer's perspective, however, the transaction serves one basic economic purpose. Reinsurance allows the reinsurer to acquire a future stream of income from the block of policies reinsured, consisting largely of future premiums to be paid on those policies. Because reinsurers anticipate a future profit from the policies they agree to reinsure, they are willing to make a sizeable up-front payment to the initial insurer for the right to share in the income.

The tax treatment of that payment, called a "ceding commission," is at issue in this case. It is undisputed that petitioner is entitled to deduct this payment; the issue is essentially one of timing. Petitioner asserts that the ceding commission can be deducted in full in the year of payment, even though that deduction would generate a substantial immediate tax loss on the reinsurance transaction. The court of appeals, on the other hand, sustained

the IRS's position that the ceding commission must be capitalized and amortized over the income-producing life of the block of policies reinsured (see I.R.C. § 167).

Though the Code contains many special provisions applicable to life insurance companies, this case is controlled by principles that govern all taxpayers. It is hornbook law that a taxpayer cannot deduct in the year of payment the cost of acquiring an income producing interest, tangible or intangible, with a useful life extending substantially beyond the taxable year. Instead, the acquisition cost must be capitalized and amortized over an appropriate period. Application of that principle compels the conclusion that ceding commissions, which represent the acquisition cost of an intangible right to income stretching many years into the future, must be capitalized and amortized over the life of the policies reinsured—both in the assumption reinsurance context, where the issue is well settled, and in the indemnity reinsurance context involved here.

A. Ceding Commissions in Both Indemnity Reinsurance and Assumption Reinsurance Transactions Are Paid to Acquire an Intangible Right in a Block of Policies, Which Is Expected To Produce Income Over Future Periods

There are several varieties of reinsurance transactions, all of which share the common element of allowing the reinsured to pass on all or part of the liability on its policies to the reinsurer. These transactions are generally divided into two broad categories: assumption reinsurance and indemnity reinsurance.

In assumption reinsurance, the reinsurer takes over all or part of the insurance business of the reinsured or ceding company and becomes directly liable to the policyholders involved for the liabilities it has assumed. In return for being relieved of liability, the initial insurer ordinarily transfers to the reinsurer a commensurate portion of the

assets backing the reserves it has established out of past premiums, and the reinsurer sets up its own reserves to cover the payment of future policy benefits. See D. McGill, *Life Insurance* 431-432 (1967).[8] Thereafter, the reinsurer treats the policies as its own, earning income from premium receipts and the investment interest on the assets backing the reserves, and ultimately recapturing any excess reserves not needed to pay benefits.

Assumption reinsurers compensate the ceding company for the right to obtain the future income from the block of policies. The consideration paid in such a transaction depends upon the maturity of the policies in question and the parties' perception of their future profitability. When the parties believe that future premiums are likely to be more than sufficient to cover projected liabilities, the reinsurer ordinarily will not insist on the full transfer of the assets corresponding to the reinsured's reserves, but will agree to pay the initial insurer consideration for the opportunity to receive the projected profits on those policies. See *Southwestern Life Ins. Co.* v. *United States,* 560 F.2d

[8] In transferring assets covering its reserves, the initial insurer may very well be relinquishing a built-in profit to the reinsurer. The profit element in the reserves arises from the fact that state law generally requires insurance companies to make conservative assumptions about mortality and investment gains. See, *e.g.*, Tr. 49-50. This has the effect of inflating the reserves beyond what is actually necessary to pay the future benefits covered by the reserves. Insurance companies recapture this "hidden profit" when the liability for benefits associated with the reserves is extinguished. The Eighth Circuit recognized this point in discussing the potential financial rewards for a reinsurer (there, in an indemnity transaction): "The block of reinsurance acquired by taxpayer has positive economic value precisely because the required reserves exceed the true economic liabilities on the underlying policies." *Prairie States,* 828 F.2d at 1231. "As the policies mature and benefits are paid," the court explained, "there will be excess funds remaining in the reserve when all of taxpayer's obligations with respect to the reinsured policies have been fully performed" (*ibid.*).

627, 640 (5th Cir. 1977), cert. denied, 435 U.S. 995 (1978). The payment from the reinsurer to the initial insurer is called a ceding commission. It is well settled that this ceding commission is not immediately deductible, but rather must be amortized over the period during which the policies are expected to produce future income. See note 12, *infra.* In sum, an assumption reinsurance transaction takes the initial insurer out of the picture entirely on a block of insurance business, and the reinsurer pays a ceding commission that represents the price of obtaining that business.

The broad category of indemnity reinsurance consists of several different types of transactions. All of them differ from assumption insurance in one respect—the reinsurer does not become directly liable to policyholders with respect to the reinsured liability, but agrees only to indemnify the ceding company for all or part of its losses on a block of policies. The initial insurer remains as a conduit between the policyholders and the reinsurer (by continuing to service the policies, collect premiums, and pay benefits). The initial insurer may also have the right to recapture all or part of the reinsured risks. See generally McGill, *supra,* at 432-434. In other respects, however, indemnity insurance may be similar to assumption reinsurance.

The simplest form of indemnity reinsurance is risk premium (or "yearly renewable term") reinsurance, which is similar to a traditional insurance contract. The initial insurer simply pays a premium to the reinsurer for protection against identified losses under policies it has directly written, and the reinsurer sets up its own reserves to cover the reinsured risks. See S. Rep. No. 291, 86th Cong., 1st Sess. 39 (1959); D. McGill, *supra,* at 435-437. There is no apparent reason for the payment of a "ceding commis-

sion" by the reinsurer in this type of transaction, and hence it does not involve the tax question at issue here.

The type of indemnity insurance involved in this case, coinsurance, is much more analogous to assumption reinsurance. Conventional coinsurance involves a kind of sharing arrangement under which the initial insurer and the reinsurer share in the liabilities and profits generated by the reinsured policies. Apart from the differences in the duration and form of the transactions—namely, that the reinsurer does not become directly liable to the policyholders or collect premiums directly from them—the assumption reinsurer and the coinsurance reinsurer have essentially the same financial benefits and obligations. In both cases, the reinsurer must carry the reserves to cover its specified share of the liabilities and ordinarily acquires the right to a concomitant share of the future premiums to be paid on the reinsured policies. And in both cases, a ceding commission is paid by the reinsurer to the reinsured for the right to share in the future income stream.[9]

The taxation of life insurance companies is governed by the intricate provisions of Sections 801-820 of the Code. In 1959, those provisions were amended to tax life insurance companies, not only on investment income, but also on underwriting gains derived from premium income. See *Commissioner* v. *Standard Life & Accident Ins. Co.*, 433

[9] Some of the transactions in this case were "modified coinsurance" transactions in which the ceding company continues to maintain the entire reserve, though it is entitled to indemnification for a specified percentage of losses and obligated to remit to the reinsurer a corresponding share of investment and premium income (see note 3, *supra*). See D. McGill, *supra,* at 438-440. Since the parties availed themselves of the Section 820 election, the transactions were treated for tax purposes as though each was a conventional coinsurance transaction. See note 4, *supra; United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725, 747-748 (1977).

U.S. 148, 152-154 (1977). The provisions establish a complex, three-phase system for calculating a company's income. See generally *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235 n.2 (1965). This case does not implicate the details of that calculation. The question here concerns the treatment of ceding commissions in connection with the reinsurer's "gain from operations," specifically, the calculation of its adjusted gross premium income under Section 809(c)(1). That Section provides for the inclusion in gain from operations of "[t]he gross amount of premiums and other considerations * * * less return premiums, and premiums and other consideration arising out of reinsurance ceded."

Petitioner contends that it is entitled to deduct its ceding commissions under this provision as offsets against gross premiums in the years of payment. That would entitle it to immediate tax deductions of $693,600 in 1975 (including the finder's fee) and $852,000 in 1976, even though these amounts were paid to obtain valuable economic interests with useful lives of seven years. The claimed deductions would generate substantial tax losses on these reinsurance transactions that would be available to offset petitioner's income from other underwriting activities. The court of appeals rejected petitioner's contention and correctly held that ceding commissions paid by indemnity reinsurers represent the acquisition costs of intangible assets that, under general tax principles, must be capitalized and amortized over the period of indemnification.

B. The Tax Treatment of Ceding Commissions Paid by an Indemnity Reinsurer Is Governed by the Rule that Costs Incurred To Acquire an Economic Interest Expected To Produce Income for Substantially More than One Year May Not Be Expensed in the Year of Payment but Must Be Capitalized and Amortized over the Interest's Useful Life

1. A fundamental premise of the tax law is that an amount expended to acquire an asset or economic interest, benefit, or advantage with an income-producing life extending substantially beyond the current taxable year may not be deducted in the year of payment but must be capitalized and amortized over its useful life. See I.R.C. § 263; *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 12 (1974); *Commissioner* v. *Lincoln Savings & Loan Assn.*, 403 U.S. 345 (1971); *Commissioner* v. *Tellier*, 383 U.S. 687, 689-690 (1966); See generally 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶¶ 20.4, 23.1.1, 23.2.6 (1981). That rule of law applies equally to the acquisition of any interest—tangible or intangible—that is expected to contribute to income in future taxable periods. See, *e.g.*, *Woodward* v. *Commissioner*, 397 U.S. 572 (1970) (professional fees expended in the appraisal of stock must be capitalized).[10]

[10] See also *Frantz* v. *Commissioner*, 784 F.2d 119, 123 (2d Cir. 1986), cert. denied, 107 S. Ct. 3262 (1987); *Sears Oil Co.* v. *Commissioner*, 359 F.2d 191, 197 (2d Cir. 1966) ("The test for determining whether items should be treated as a current expense or a capital expenditure is whether utility of expenditure survives the accounting period."); *Falstaff Beer, Inc.* v. *Commissioner*, 322 F.2d 744, 747 (5th Cir. 1963); *United States* v. *Wheeler*, 311 F.2d 60, 61-64 (5th Cir. 1962); cert. denied, 375 U.S. 818 (1963); *Darlington-Hartsville Coca-Cola Bottling Co.* v. *United States*, 393 F.2d 494, 496 (4th Cir. 1968), cert. denied, 393 U.S. 962 (1968); *Encyclopeadia Britannica, Inc.* v. *Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982); *Wells-Lee* v. *Commissioner*, 360 F.2d 665, 669-670 (8th Cir. 1966); *United States* v. *Akin*, 248 F.2d 742, 744 (10th Cir. 1957), cert. denied, 355 U.S. 956 (1958).

The ceding commissions here clearly fall within the scope and rationale of this principle. As petitioner's own expert witness essentially admitted at trial (Tr. 56-57), petitioner paid its ceding commissions to acquire an economic benefit that it fully expected to contribute to its income in future periods. In all four indemnity reinsurance transactions here, the ceding commissions paid by petitioner represented a capital investment in the reinsured policies and, therefore, are properly amortizable over the indemnification period. Departing from the basic capitalization rules, as petitioner urges, would grossly distort its income. A current deduction would mismatch the future income to be derived from the reinsured policies with the current costs of acquiring the right to that income. Such an accelerated deduction of expenses incurred to obtain future income would undermine the basic purpose of capitalization rules—to "mak[e] a meaningful allocation of the cost entailed in the use * * * of the asset to the periods to which it contributes [income]." *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 104 (1960).

The courts of appeals that have considered this issue generally have recognized that an indemnity insurer's ceding commission is inherently capital in nature. In *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110, 112 (8th Cir. 1987), the court explained that "[i]t is apparent that taxpayer, in paying $450,000 in return for the right to a percentage of the future earnings on the reinsured policies, acquired an economic benefit that it fully expected to contribute to its income in future periods." See also *Prairie States Life Ins. Co.* v. *United States*, 828 F.2d 1222, 1231 (8th Cir. 1987) (reinsurer took on the transaction to acquire an "intangible asset" with future benefit). The court of appeals in the present case also correctly recognized that the ceding commission is an expense reflecting "an estimate of the current value to the taxpayer

that is represented by having these policies on its books with the expectation of continuing premiums to be paid in the future" (Pet. App. 9a). See also *Southwestern Life Ins. Co.* v. *United States,* 560 F.2d 627, 640-641 (5th Cir. 1977), cert. denied, 435 U.S. 995 (1978); but see *Merit Life Ins. Co.* v. *Commissioner,* 853 F.2d 1435, 1441-1442 (7th Cir. 1988), petition for cert. pending, No. 88-955. That is precisely the kind of expense that must be capitalized, rather than immediately written off. Indeed, this conclusion is confirmed by a published independent accounting guide for auditing insurance companies, which states that a ceding commission "should be treated as an acquisition expense to be amortized over the premium-paying period" (*The Industry Audit Guide of Stock Life Insurance Companies,* prepared by the Committee on Insurance Accounting and Auditing of the American Institute of Certified Public Accountants, 92 (1972)).

Petitioner seeks (Br. 21 n.28) to explain away the ceding commissions as merely a form of reimbursement to the initial insurer for expenses it incurred in selling the underlying policies. But the motives that impel the initial insurer to seek the payment of a ceding commission cannot account for the willingness of the indemnity reinsurer to pay it. There is no adequate explanation for petitioner's paying a ceding commission—and thus taking on future liability far in excess of the net assets it received from Transport—except to purchase the share of future profits from the block of policies reinsured. Thus, regardless of whether the *ceding* company views the commissions as a partial reimbursement of its selling expenses, the critical fact here is that to the *reinsurer,* such ceding commissions represent the cost of an intangible right to a share of the

future income from the reinsured policies.[11]

2. It is now well settled that capitalization and amortization are required for ceding commissions that the reinsuring company expressly agrees to pay in an assumption reinsurance transaction.[12] Because there is essentially no

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[11] The situation is analogous to the purchase of a typewriter, a manufacturing plant, or, for that matter, an intangible asset such as a patent, by a business. The seller may reasonably view the price as reimbursement for his deductible expenses incurred to produce the asset, but there can be no doubt that the purchaser has paid for an asset with a useful life in excess of one year and it must capitalize, not immediately deduct, the cost of the asset. Petitioner essentially admits the capital nature of the transaction when it acknowledges (Br. 25) that "the reinsurer, like the primary insurer, expects to realize a profit from the [indemnity] insurance it issues." Petitioner's attempted qualification of this point—noting that it may actually experience an unanticipated loss (*id.* at 25 n.34)—is unavailing. That there is an element of risk or that the reinsurer may misjudge the benefits of the transaction is entirely irrelevant to understanding its business purpose at the outset when it pays for the right to share the benefits from the block of policies.

[12] See *Southwestern Life Ins. Co.* v. *United States,* 560 F.2d at 640-641 (requiring capitalization of payment that reinsurer agrees to pay to the reinsured company); *Standard Life & Accident Ins. Co.* v. *Commissioner,* 525 F.2d 786, 791 (10th Cir. 1975) (same), rev'd on other grounds, 433 U.S. 148 (1977); *Mutual Savings Life Ins. Co.* v. *United States,* 488 F.2d 1142, 1146-1147 (5th Cir. 1974) (the Florida Life transaction) (same)); *Oxford Life Ins. Co.* v. *United States,* 790 F.2d 1370, 1376 (9th Cir. 1986) (requiring capitalization of payment *to* ceding company that reinsurer agreed to net against a greater amount of consideration payable *by* the ceding company); *Kentucky Central Life Ins. Co.* v. *Commissioner,* 57 T.C. 482 (1972) (same). Such treatment is required by Section 1.817-4(d) of the Treasury Regulations on Income Tax. Some courts have, incorrectly in our view, reached a dif-

economic difference between a ceding commission paid in an assumption reinsurance transaction and one paid in an indemnity reinsurance transaction, the same capitalization rule should apply here. See *Idaho Power*, 418 U.S. at 14 (rejecting capitalization rule that would "lead to disparate treatment among taxpayers" who incur comparable expenses). Indeed, even the Tax Court acknowledged in *Beneficial Life Ins. Co.* v. *Commissioner*, 79 T.C. at 646-647, that it might "seem strange at first for * * * [assumption and indemnity reinsurance transactions] to have such different tax consequences when they are, at heart, so similar."

While there are some variations between the forms of assumption reinsurance and indemnity reinsurance, those differences have no bearing on the economic substance or purpose of their common element—the payment of a ceding commission—and they do not justify different tax treatment. We fully recognize that assumption reinsurers take on direct liability to the policyholders (while indemnity reinsurers do not), that assumption reinsurers will typi-

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ferent result when, *unlike the agreements in question here*, the reinsurer did not expressly agree to pay any such "ceding commission," but simply agreed to accept, as consideration for assuming liabilities on the reinsured policies, an amount that was less than the required reserves. See and compare Section 1.817-4(d), Examples (1) and (3), of the Treasury Regulations on Income Tax, with *Mutual Savings Life Ins. Co.* v. *United States*, 488 F.2d at 1145-1146 (the Georgia life transaction) and *Security Benefit Life Ins. Co.* v. *United States*, 726 F.2d 1491 (10th Cir. 1984). We believe the latter cases were erroneously decided, but they are plainly distinguishable from this case (and, in any event, both relied on an example given in an earlier version of Section 1.817-4(d) of the Regulations that has since been changed). See *Oxford Life Ins. Co.* v. *United States*, 790 F.2d at 1374-1375.

cally assume 100 percent of the liabilities on the policies (while indemnity reinsurers may reinsure all or part of the liability), and that assumption reinsurers take permanent possession of the reinsured business (while indemnity reinsurers may allow the initial insurer to recapture the reinsured business). See *McGill, supra* at 435-440. These differences, however, do not alter the essential characteristics of ceding commissions. It is entirely immaterial which company is "directly" liable to policyholders;[13] the issue here concerns only the taxation of the price of shifting the income stream under the block of reinsured policies from the ceding company to the reinsurer.[14] Moreover, assump-

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[13] Indeed, the fact that the indemnity reinsurer is not "directly" liable to the policy holder is irrelevant, as a practical matter, to its ultimate liability to cover the benefits payable under the reinsured policies. Indemnity reinsurance agreements generally provide (and indeed, are often required by law to provide) that the insolvency of the ceding company will not release the reinsurer from its obligation to pay unsatisfied claimants its share of the benefits payable. See McGill, *supra*, at 444. A provision generally to this effect was set forth in the agreements at issue here. Thus, just as in assumption reinsurance, the indemnity reinsurer stands essentially in the shoes of the initial insurer from the vantage point of both its financial rewards and its financial obligations.

[14] It could not be contended, for example, that, if an assumption reinsurer simultaneously entered into a management agreement with the initial insurer for the latter to continue to collect premiums, pay benefits, and so forth (for a fee), the assumption reinsurer would be any less the "owner" of the income-producing interests under the policies. By the same token, the indemnity reinsurer is no less the "owner" of an intangible interest in future income simply because it does not pay benefits to, or receive premiums directly from, policyholders.

tion reinsurance cannot be distinguished from indemnity reinsurance on the ground that an entire block of policies is shifted to the reinsurer, rather than only some percentage of it. The percentage of policies reinsured in an indemnity agreement can easily represent the bulk of the interest in the policies, as it did in this case. But even a lesser percentage of reinsurance would provide the reinsurer with a share in a future income stream, for which the reinsurer pays an acquisition cost in the form of a ceding commission. Finally, the duration of an indemnity reinsurance transaction may be shorter than that of an assumption transaction, but the length of the agreement bears only on the appropriate amortization period, not on whether the acquisition cost is capital in nature. The fact that the indemnity insurer acquires only a portion of future income rights (rather than all of the rights) cannot spare it from capitalizing its acquisition costs, any more than the purchaser of a life estate in property can avoid capitalizing its acquisition costs because it did not purchase the fee simple.[15]

[15] Petitioner relies (Br. 11, 15 n.19, 23 n.30, 26 n.35) on *Oxford Life Ins. Co.* v. *United States, supra*, 790 F.2d 1370, 1376 (9th Cir. 1988), in which the court suggested in passing that assumption reinsurers and indemnity reinsurers may be accorded different tax treatment with respect to ceding commissions. But the proper treatment of indemnity reinsurance was not at issue in that case, since the taxpayer in *Oxford* had undertaken only an assumption reinsurance transaction. Moreover, in a more recent decision involving the same taxpayer, this time concerning an indemnity reinsurance transaction, a district court in the Ninth Circuit declined to rely on the dicta cited above, but instead adopted the reasoning and holding of the Eighth Circuit's decision in *Prairie States. Oxford Life Ins. Co.* v. *United States*, No. CIV 84-959 PHX RGS (D. Ariz. Oct. 15, 1987), appeal pending (9th Cir. No. 88-2955). The district court thus held that ceding commissions in *indemnity* transactions must be capitalized and amortized, just as ceding commissions in *assumption* transactions must be capitalized and amortized.

Petitioner argues (Br. 16) that because Congress in 1959 wrote several provisions into the Code that apply exclusively to assumption reinsurance (Sections 806(a) and 809(d)(7), for example), it follows that assumption and indemnity reinsurance should also be accorded different treatment here. But those provisions respond to specific issues relating to the differences in the forms of the transactions that we identified above (and that are irrelevant to the tax treatment of ceding commissions). None of those provisions suggest that the 1959 Congress viewed assumption reinsurance purely as a "sale of assets" and indemnity reinsurance purely as the issuance of new "insurance," thus justifying vastly different tax treatment of the essentially similar ceding commissions.[16] In fact, both kinds of

[16] Petitioner merely cites (Br. 14-16) Sections 809(d)(7) and 806(a) without explaining how those provisions fit its theory about ceding commissions. Those sections are completely unrelated to payments of such commissions. Section 809(d)(7) allows a deduction for amounts paid by a *reinsured company* under an assumption reinsurance agreement. That provision illustrates only that Congress intended to maintain *tax parity* between indemnity and assumption reinsurance. In indemnity reinsurance the initial insurer continues to receive premiums that are includible in its own income under Section 809(c)(1), but can then use that provision to subtract from its income premiums paid to reinsurers. In assumption reinsurance the initial insurer ceases to receive premiums included in income under Section 809(c)(1), and therefore cannot subtract its payments to the reinsurer from *its* gross premium income under that section, even though a deduction is obviously appropriate. Section 809(d)(7) thus fills a gap by allowing initial insurers in assumption reinsurance a deduction already available in indemnity transactions under Section 809(c)(1).

Similarly, petitioner points (Br. 16) to Section 806(a) of the Code (which provides for allocation of reserves in assumption reinsurance and specifies that it does not apply to indemnity reinsurance). That Section reflects Congress's recognition that assumption reinsurance and indemnity reinsurance generally differ in their duration. In assumption reinsurance, the reinsurer assumes the reserves for the life

transactions partake of elements of a sale and of an insurance transaction; the ceding commission aspect of both, however, requires amortization tax treatment, regardless of how the transaction is characterized.

Petitioner errs in contending that the legislative history establishes that Congress "intend[ed] to treat indemnity reinsurance and assumption reinsurance differently for tax purposes" (Pet. Br. 17, 23 n.32). Read in context, the legislative history says nothing that supports the deductibility of ceding commissions. As petitioner notes, the Senate Committee report stated in passing that, "as distinct from assumption reinsurance, the initial risk in [indemnity reinsurance] remains with the insurer but he covers this risk by reinsuring part or all of a contract with another insurance company." S. Rep. No. 291, *supra,* at 38. But, contrary to petitioner's suggestion (Br. 17), the Committee's purpose was not to discuss the tax treatment of assumption reinsurance as compared to indemnity reinsurance, or to deal with ceding commissions in either type of transaction. Rather, that language introduced the Committee's analysis of modified coinsurance transactions only with respect to one item: the potential double taxation of investment income paid to the reinsurer with respect to the reserves retained by the initial insurer.[17] The only reasonable conclusion to be drawn from this discussion is

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of the policies, while in indemnity reinsurance, the reinsurer assumes liability for the reserves for a period of time that may be less than the life of the policies. This difference accounts for the two types of reinsurance being treated differently with respect to reserve allocation. But petitioner never explains how the different treatment of assumption and indemnity reinsurance under Section 806(a) has anything to do with ceding commissions.

[17] After analyzing the problem in this area, the Committee proposed a solution, which was embodied in Section 820. S. Rep. 291, *supra*, at 39.

that Congress paid careful attention to the details of life insurance company taxation and adverted to the problems it sought to solve. Yet nowhere in the legislative history did Congress ever articulate a desire to relieve indemnity reinsurers from the capitalization rules otherwise applicable to taxpayers who make current expenditures for future economic benefits.

It is true that capitalization of ceding commissions paid by assumption reinsurers is specifically required by Treas. Reg. § 1.817-4(d)(2)(ii)(B), while there is no analogous regulation addressing the treatment of ceding commissions paid in indemnity transactions. But, while this regulation does not by its terms apply to indemnity reinsurers, the principles underlying it most certainly do. It would read far too much into the absence of a parallel regulation with respect to indemnity reinsurance to find, as petitioners contend (Br. 18-20), that the IRS intended indemnity reinsurers to take a current deduction of their ceding commissions.[18] As the Eighth Circuit recognized, "the inap-

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[18] Treas. Reg. 1-817-4(d)(2)(ii) was promulgated in the wake of a transitional rule for assumption reinsurance transactions (Section 817(e)) that lapsed beginning in 1959. The transitional rule related to capital gains or losses in assumption transactions in 1958, and provided that the policies sold in such an assumption transaction would be treated as the sale of a capital asset. This rule meant that the *initial insurer*'s gains from 1958 transactions would not be taxed, because life insurance companies' capital gains were not taxable until 1959. S. Rep. No. 291, *supra,* at 29-30. "Following the expiration of that transitional rule, the Code left open the tax treatment of such transactions, and the regulation is intended to govern transactions after December 31, 1957." *Prairie States,* 828 F.2d at 1230 n.7 (citation omitted). See also *Beneficial Life Ins. Co.* v. *Commissioner,* 79 T.C. at 645 n.22. The regulations provide that after 1958, the initial insurer in an assumption transaction cannot receive favorable capital gains treatment for the transfer of policies. The regulations go on to clarify, however, that the assumption reinsurers' interest in the policies ac-

plicability of the regulation to taxpayer's indemnity transaction does not mean that the transaction is not governed, under the applicable statutory provisions, by principles similar to those illustrated in the regulation." *Prairie States*, 828 F.2d at 1232.[19] "Rather," the court explained, "the regulation is silent as to their treatment" (*ibid.*), and the gap must be filled by application of fundamental tax principles.[20]

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quired is still capital in nature (thus requiring the ceding commission to be amortized). The particular need for the IRS to clarify the capital gains issue for *initial insurers* in assumption transactions may explain why it promulgated a regulation for assumption transactions, but not indemnity transactions. Contrary to petitioner's suggestion (Br. 19 n.26), however, nothing in this history has the slightest significance for determining how to treat the ceding commissions paid by the *reinsuring company* in this case.

[19] The Tax Court in *Beneficial Life*, 79 T.C. 627, 645, and in this case, Pet. App. 17a, apparently felt compelled to draw a negative implication from the assumption regulation, even though it recognized that its holding led to a "strange" result (*id.* at 19a). But the regulation on its face does not prescribe anything about indemnity reinsurers, and it need not be read to imply anything on that subject. Surely, the IRS, when it needs to deal with a particular type of transaction by regulation, is not required to deal at the same time with all other transactions that might be comparable to the one being specifically addressed, in order to avoid the risk that implications for similar transactions will be read into the regulation.

[20] Petitioner also erroneously suggests (Br. 13 n.14) that the IRS formerly took the view that ceding commissions in indemnity transactions are deductible in the year of payment, citing Rev. Rul. 70-552, 1970-2 C.B. 141, 142. In that ruling, the IRS was asked to consider the tax treatment, not of the kind of up-front ceding commissions involved here, but of a very different kind of payment, albeit one referred to as a "ceding commission." The ceding commissions there (on casualty reinsurance) were paid *annually* to cover expenses incurred by the initial insurer. Thus, the situation addressed in the ruling did not present a capitalization issue, and it bears no relevance whatever to the question here of an "up-front" ceding commission paid to obtain in-

Petitioner argues at length (Br. 2, 10-13, 15, 21, 24-25) that indemnity reinsurance is just a form of "insurance." Despite petitioner's insistence on this characterization, at bottom it makes no difference to the tax treatment of *ceding commissions* whether indemnity insurance is called "insurance" for one purpose or another, for the name used cannot alter the underlying, long-term financial benefits for which the reinsurer pays a ceding commission. As an industry representative explained to the Senate Finance Committee in its 1959 hearings, "[t]he original insurer, desiring indemnity, is content to share its policies' earning potentials; the reinsure[r], willing to accept a risk under a collateral indemnity contract, can rightfully name its price in terms of a share in the earnings and profits of the contractual adventure." Hearings on H.R. 4245, 86th Cong., 1st. Sess. 607 (1959) (statement of Henry F. Rood). Quite simply, "reinsurance has the effect of dividing a single source of income into segments" (*id.* at 610).[21] The segment of future income acquired by the indemnity reinsurer is paid for by the negotiated ceding commission. There is no reason to treat the expenditure as other than an intrinsically capital outlay.

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come in future periods. When the IRS did address that issue for the first time in a Revenue Ruling, it distinguished its earlier handling of the annual ceding commissions and concluded that "the 'up-front ceding commission' is paid with respect to the acquisition of an agreement or contract with a readily determinable useful life." Rev. Rul. 82-69, 1982-1 C.B. 102, 103. Accordingly, it ruled that such a ceding commission "must be amortized over the term of the agreement." *Ibid.*

[21] The statement was made to urge Congress to recognize the risk of double taxation in the modified coinsurance context. See *Consumer Life*, 430 U.S. at 747. There is no mention of ceding commissions – and certainly no suggestion that they should be deductible – in that statement.

II. NO PROVISION OF THE CODE OVERRIDES THE GENERAL CAPITALIZATION PRINCIPLE TO PERMIT THE CURRENT DEDUCTION OF CEDING COMMISSIONS

The capitalization rules that generally apply to payments for future benefits, such as the ceding commission here, are controlling unless Congress specifically withdrew the application of those rules from taxpayers in petitioner's situation. Such an exception would depart from the tax principles generally applicable to all other taxpayers, and an intent to create that sort of disparity should not lightly be imputed to Congress. Although petitioner relies on three sections of the Code to support the deduction of ceding commissions in the year paid, none of those provisions provides the dispensation from the basic rules of capitalization that petitioner seeks.

A. The Ceding Commissions Payable to Transport Under the Coinsurance Agreements Cannot Be Used to Reduce Gross Premiums Under Section 809(c)(1) of the Code

Section 809(c)(1) requires that life insurance companies compute their actual premiums as a preliminary step in determining taxable "gain from operations." The first sentence of that Section requires life insurance companies to include in income "[t]he gross amount of premiums and other consideration (including * * * consideration in respect of assuming liabilities under contracts not issued by the taxpayer) * * * less return premiums, and premiums and other consideration arising out of reinsurance ceded." The second sentence excludes certain types of payments from "return premiums." It states, "[e]xcept in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance

ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of management shall not be included in return premiums."

Petitioner erroneously contends (Br. 22-23) that Section 809(c)(1) and Treas. Reg. §_1.809-4(a)(1)(ii) mandate the inclusion of "ceding commissions" in "return premiums," with the necessary effect of reducing gross premium income in the year that ceding commissions are paid. This contention ascribes to Congress and the IRS an affirmative intent to require reinsurers to reduce their current income by the amount of payments made to acquire future benefits. There is no plausible basis for that conclusion. Rather, the manifest purpose of Section 809(c)(1) is far narrower in scope. Read in context, Section 809(c)(1) permits the deduction only of "illusory" premium income that, with the benefit of hindsight, would never have been included in premium income in the first place. For example, amounts returned to a policyholder (under a provision fixed in the policy), amounts refunded by a reinsurer to the initial insurer pursuant to experience-based formulas or for similar reasons, or amounts paid by an initial insurer to obtain reinsurance are all payments that are legitimately subtracted from gross premium income under Section 809(c)(1). But that Section was never intended to provide a deduction for large, up-front payments that entitle reinsurers to a share of future profits from a block of policies.

Section 809(c)(1), on its face, is focused on the determination of premium *income*. Thus, it first provides for taking the "gross amount of premiums and other consideration" into account and then for elimination from such "gross premiums" two items, *viz.* "return premiums"

and "premiums and other consideration arising out of reinsurance ceded." As expressed by the Eighth Circuit, both types of adjustments were intended "to eliminate from the 'gross amount of premiums and other consideration' those portions of premiums received which do not, in the end, 'belong' to the company in question, but which must be returned to the policy holder or turned over to or shared with another company under an indemnity reinsurance contract." *Modern American Life Insurance Co.* v. *Commissioner*, 830 F.2d at 114; *Prairie States Life Ins. Co.* v. *United States*, *supra*, 828 F.2d at 1233. Ceding commissions in no way constitute "portions of premiums received which do not, in the end, 'belong' to the company in question" (*Modern American*, 830 F.2d at 114); rather, they represent consideration paid at the outset of a reinsurance transaction to acquire a profitable stream of premium income.

To begin with, ceding commissions are not "return premiums." Petitioner argues (Br. 22-23) that Treas. Reg. 1.809-4(a)(1)(ii) brings ceding commissions within the ambit of return premiums, but that regulation provides no assistance to petitioner. The regulation defines "return premiums" to include "amounts of premiums or other consideration *returned* to another life insurance company in respect of reinsurance ceded." *Ibid.* (emphasis added). The ceding commissions in this case are not "consideration returned" to the initial insurer. The true nature of a ceding commission is a payment made contemporaneously with the closing of the transaction in order to acquire valuable future rights to premium income. The up-front ceding commissions are not being "returned" to the initial insurer, and there is no reason to strain the language of the regulation to include them.

The legislative materials confirm that the words "return premiums" were never meant to cover ceding commissions in indemnity reinsurance transactions. The legislative history identifies only one situation in which an indemnity reinsurer can rely on Section 809(c)(1) to reduce its premium income by sums paid to the initial insurer—and that situation is *not* the payment of ceding commissions. The Senate Finance Committee observed that if the indemnity reinsurer must pay a portion of premiums "ceded" back to the initial insurer pursuant to an experience rated refund clause, the reinsurer can reduce its gross premium income by that amount. See S. Rep. No. 291, *supra*, at 39 ("the experience refunds paid by the reinsurer to the initial insurer are treated as reductions in premium income of the reinsurer"). [22] "Experience refunds," however, are nothing like the ceding commissions here. Experience refunds simply readjust the amounts of premiums paid to the reinsurer to reflect the fact that fewer benefits had to be paid on the reinsured risks than had been projected, or that other unanticipated savings materialized. McGill, *supra*, at 445. That type of payment is properly viewed as a "return" to the initial insurer of a portion of the premiums the reinsurer previously received.[23] But it cannot seriously be

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[22] The original House proposal was somewhat unclear on the deductibility of such payments by the reinsurer, but amendments made by the Senate (including the addition of the first clause of the second sentence of Section 809(c)(1)) served to clarify that they would be deductible by the reinsurer under Section 809(c)(1), even though similar refunds made to policyholders by the original insurer might be treated only as dividends (which are deductible under Section 809(d)(3) only within certain specified limits). See S. Rep. No. 291, *supra*, at 39; *Prairie States*, 828 F.2d at 1226-1227.

[23] On the same basis, a reinsurer could reduce its gross premium income under Section 809(c)(1) if a portion of the premiums it received from the ceding company must be returned, for example, to cover the

contended that a "ceding commission," paid to obtain the future profits to be generated by the reinsured policies, is like an "experience refund," or any other permissible adjustment to premium income under Section 809(c)(1)'s provision for return premiums.[24]

Likewise, there is no basis for subtracting ceding commissions from income under the branch of Section 809(c)(1) allowing a deduction for "premiums and other consideration arising out of reinsurance ceded." Indeed, petitioner does not even contend that that language is applicable to the ceding commissions here (see Br. 22-24). It

latter's "return premiums" to policy holders. Again, that would be an adjustment that is necessary to reflect accurately the true premium income of the reinsurer. In addition, modified coinsurance agreements typically provide for the payment back to the reinsurer of a specified portion of the premiums received at the outset, and for the subsequent return of amounts necessary to cover specified expenses and additions to reserves. See, McGill, *supra* at 438-440. Those payments might also be regarded as the type that would appropriately be considered "return premiums" subtracted from income under Section 809(c)(1).

[24] Similarly, there is no basis for treating the payment of a "finder's fee" as an adjustment to gross premiums, as petitioner advocates (Br. 7 n. 5). As we have noted (note 7, *supra*), the Tax Court was in error in asserting that the Commissioner had conceded that if the ceding commissions were deductible under Section 809(c)(1), then the finder's fee would also be deductible on the same basis. Indeed, there is not even a colorable basis under Section 809(c)(1) for allowing such a deduction. It is well settled that such finder's fees in connection with the acquisition of assets must be capitalized as part of the cost basis of such assets. See, 1 B. Bittker, *supra*, ¶ 20.4.2, at 20-59; 2 *id.* ¶41.2-3, at 41-12. The finder's fee, of course, represents an insignificant portion of the deduction claimed by petitioner. Our principal point is that there is no more reason to allow an immediate deduction for the amounts paid directly to acquire the future benefits provided by these agreements (the ceding commission) than there is to allow such a deduction for amounts paid to a third party for bringing this opportunity to petitioner's attention (the finder's fee).

is evident that Section 809(c)(1)'s allowance for "premiums and other consideration arising out of reinsurance ceded" permits only the *ceding company* to reduce its premium income by amounts paid to a reinsurer arising out of indemnity reinsurance agreements. Properly construed, that deduction is simply the indemnity insurance analogue to Section 809(d)(7), which permits the ceding company in assumption reinsurance to deduct consideration paid to the reinsurer (see note 16, *supra*).[25]

The structure of the Code confirms that Section 809(c)(1) has a limited focus that in no way was designed to alter the usual rules of capitalization. Section 809(c)(1) is one of three items grouped under the heading "Gross Amounts," each of which is designed to capture sources of income. In contrast, the "Deductions" from income are in a separate subsection, Section 809(d). There, Congress provided for twelve deductions specially tailored for life insurance companies. If it had intended to do so, subsection (d) was the obvious place for Congress to have provided for the deduction of such a major item as a reinsurance ceding commission.

Nor does the somewhat sparse legislative history of Section 809(c)(1) justify construing it as a significant depart-

[25] Section 809(d)(7) provides for the deduction of "consideration (*other than consideration arising out of reinsurance ceded*) in respect of the assumption by another person of liabilities under insurance or annuity contracts • • •." *Id.* (emphasis added). The use of the identical language—"consideration arising out of reinsurance ceded"—in the two neighboring Sections (809(c)(1) and (d)(7)) suggests that Congress intended the same meaning to control in each. Since the words "consideration arising out of reinsurance ceded" in Section 809(d)(7) refer only to payments by the reinsured company (see S. Rep. 291, *supra*, at 55; H.R. Rep. No. 34, 86th Cong., 1st Sess. 30 (1959)), the same construction is appropriate for the identical language in Section 809(c)(1), which thus cannot cover ceding commissions paid by the reinsurer.

ture from settled capitalization rules that do not permit the deduction of ceding commissions paid in indemnity reinsurance transactions. Although petitioner struggles to find support in the legislative history (Br. 10, 11, 14 n.17, 17-18, 23 n.32, 26), there is simply no indication that Congress actually intended Section 809(c)(1) to allow premium income to be adjusted by subtracting ceding commissions. The Committee reports make no reference to ceding commissions in the explanations of the proposed language that became Section 809(c)(1), or elsewhere.[26] Given the exten-

[26] Relevant portions of the Committee reports contain no reference to ceding commissions, although they cover numerous other (dissimilar) types of adjustments. For example, the Senate Committee's technical analysis explained Section 809(c)(1) this way:

> Subsection (c) specifies three categories of receipt items which are taken into account in determining whether there is a gain or loss from operations under Section 809. Under paragraph [1] the gross amount of all premiums and other consideration on insurance and annuity contracts (including supplementary contracts) is taken into account; less return premiums, and premiums and other consideration arising out of reinsurance ceded. The premiums and other consideration taken into account include advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer. In excluding return premiums, amounts returned (by whatever name called) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management are not to be treated as return premiums, except in the case of return premiums or other consideration returned to another life insurance company under an indemnity reinsurance contract. Furthermore, amounts rebated or rendered due to policy cancellations or to erroneously computed premiums are to be treated as return premiums.

S. Rep. No. 291, *supra*, at 54; see also *id.* at 21. The House Committee report contains a similar discussion. H.R. Rep. No. 34, *supra*, at 29-30. The floor debate on the bill did not touch on issues relating to "reinsurance ceded."

sive consideration by Congress of the intricacies of life insurance taxation, it is not plausible to believe that the extraordinary income tax benefit petitioner now seeks, which is incompatible with tax treatment for other taxpayers who incur present outlays for future benefits, somehow "slipped through" the process without any legislative consideration at all.

Indeed, that point is confirmed by the attention to detail evidenced in the legislative history. The Senate Committee report took the trouble to note that an adjustment was appropriate for "amounts rebated * * * due to policy cancellations or to erroneously computed premiums." S. Rep. No. 291, *supra*, at 54. Likewise, as we have noted, the report mentions that reinsurers could subtract from their gross premiums "experience refunds" paid to the ceding company. See *id.* at 39. The same Congress that expressly tinkered with the details of "gross premiums" by carving out "erroneously computed premiums" and "experience refunds" as items of adjustment cannot reasonably be thought to have altered basic taxation rules for capitalizing acquisition costs, without any comment at all. Cf. *Church of Scientology* v. *IRS*, 108 S. Ct. 271, 276 (1987). Indeed, it would be highly incongruous for Congress to remark on the relatively minor payment item of "experience refunds," but totally ignore the much more economically significant "ceding commissions." The only rational explanation is that Congress framed Section 809(c)(1) to measure "premium income" fairly—in light of the practice of insurers to relinquish or return some premiums to others and therefore not enjoy their benefit—but did not intend to create a new type of deduction for the capital expense of a ceding commission.[27]

[27] Petitioner relies heavily (Br. 17-18, 25 n.33) on the comments of the staff of the Joint Committee on Taxation, twenty-five years after

B. The Ceding Commissions Are Not "Ordinary and Necessary" Expenses Deductible Under Section 809(d)(12) of the Code

Petitioner makes the alternative argument (Br. 24-26) that ceding commissions are ordinary and necessary expenses of its reinsurance business, and are therefore deductible in the year incurred under Section 809(d)(12).[28] Petitioner reasons that just as commissions paid to agents who sell policies to the public are deductible in the year

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the fact. Those comments could not conceivably shed any light on the intent of the 86th Congress that wrote Section 809(c)(1), cf. *Weinberger* v. *Rossi*, 456 U.S. 25, 35 (1981) ("*post hoc* statements of a Congressional Committee are not entitled to much weight"), but, in any event, they do not aid petitioner on their merits. The staff report remarked, in passing, that assumption reinsurance is treated as the "sale of a block of business," while indemnity reinsurance "describes a continuing insurance relationship between the ceding company and the reinsurer." Report of the Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 1st. Sess 633 (Joint Comm. Print 1984). The staff never spoke to the tax treatment of ceding commissions, and its comments may very well have been prompted by a reading of the Code provisions regarding the two types of reinsurance that we have noted—and distinguished from the present issue (note 16, *supra*). Similarly, Technical Advice Memorandum (TAM) 8742004, IRS Letter Rul. Rep. (CCH) (June 30, 1987) (see Pet. Br. 18), which in any event may not be cited as precedent (I.R.C. § 6110(j)(3)), in no way suggests that the costs of acquiring indemnity reinsurance policies are any less subject to capitalization than the costs of acquiring assumption reinsurance policies.

[28] Section 809(d)(12) "implicitly incorporat[es] I.R.C. § 162(a), which provides a deduction for 'ordinary and necessary expenses' in conducting a business." *Prairie States*, 828 F.2d at 1233. (Section 809(d)(12) was renumbered Section 809(d)(11) by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1901(a)(98)(B)(i), 90 Stat. 1520.)

incurred, so should ceding commissions paid by reinsurers to the reinsured company be deductible. But the argument rests on a false analogy. The ceding commissions a reinsurer pays the ceding company are not remotely similar to the commissions that an insurance company pays to its agents for personal services rendered in writing new policies. Indeed, virtually the only point of similarity is that both sorts of payments are commonly referred to as "commissions."

First, in the case of a single policy, the insurer does not pay the *policyholder* for agreeing to purchase life insurance. That, however, is exactly what happens with a ceding commission. A reinsurer pays a ceding commission, not to compensate its agent for selling a policy, but to induce the initial insurer to transfer to it—via a reinsurance transaction—a valuable future income stream in a block of policies. A payment to another party to induce it to assign contract rights expected to produce future profits would not typically be regarded as an "ordinary and necessary" business expense. It certainly cannot be equated with standard agent's commissions that are basically a form of salary expenses. See *Southwestern Life Ins. Co.* v. *United States*, 560 F.2d at 641. The ceding commission paid for the reinsurer's share is thus no more akin to ordinary agent's commissions than is the similar ceding commission paid to acquire policies in an assumption transaction.

The fact that Congress intended to allow a current deduction for the routine expenses incurred by a company in connection with the writing of new insurance policies is made clear in the legislative history of the 1959 Act. See S. Rep. No. 291, *supra*, at 7, 9; H.R. Rep. No. 34, 86th Cong., 1st. Sess. 4 (1959). But a ceding commission bears

none of the "ordinary and necessary" attributes of agent's commissions and the other expenses of writing new policies (medical examinations, administrative overhead, etc.) that are currently deductible. And there is no indication at all in the legislative history that Congress viewed ceding commissions as analogous to those routine expenses or as deserving of similar tax treatment.

In short, petitioner simply has not incurred "a sales expense" in paying a ceding commission to place new business on its books, and thus the ceding commissions are not deductible as such under Code Sections 162 and 809(d)(12). Rather, as in the case of assumption reinsurance, ceding commissions in indemnity transactions simply reflect the current value to the reinsurer of the rights acquired with respect to the reinsured policies themselves. See *Modern American Life Ins. Co.* v. *Commissioner, supra; Prairie States Life Ins. Co., supra.*

C. The NAIC Methods of Accounting for Ceding Commissions Are Not Controlling Under Section 818 of the Code Because They Are Inconsistent with the Accrual Method of Accounting, Which Takes Precedence over the NAIC-Approved Method of Computation.

Petitioner argues (Br. 5-6, 26-30) that because ceding commissions are currently deductible for purposes of the National Association of Insurance Commissioners (NAIC) annual statement, it follows that the ceding commissions must be currently deductible for income tax purposes as well. That argument is unpersuasive. Section 818(a) requires life insurance companies to make "computations entering into the determination of taxes imposed by this part * * * in a manner consistent with" the annual statement approved by the NAIC, *except* when that would be inconsistent with accrual accounting rules. 26 U.S.C. 818(a); *Standard Life*, 433 U.S. at 158-159. Thus, when

the "rules of accrual accounting dictate a contrary result," *id.* at 159, the NAIC procedures must yield. That is the case here with respect to ceding commissions.

Accrual accounting requires the acquisition costs of a future benefit to be capitalized, rather than written off in the year paid. Section 1.461-1(a)(2) of the Treasury Regulations on Income Tax embodies that rule as follows (emphasis added):

> *Taxpayer using an accrual method.*—Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. ***However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred.***

See also 4 B. Bittker, *supra*, at 105-69. That regulation forbids the complete deduction, under an accrual accounting method, of outlays that serve to create identifiable economic benefits extending over more than one year. In mandating that an accrual method of accounting take precedence over NAIC computational procedures when they are inconsistent with each other, Congress made this capitalization principle controlling for life insurance companies, just as it is for all other accrual method taxpayers.[29]

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[29] The Tax Court (which ruled in petitioner's favor on the question presented here) has never suggested that Section 818(a) had any bearing whatsoever on the resolution of this question. And, of course, neither the Fifth Circuit here nor the Eighth Circuit in *Prairie States* and *Modern American* accepted such an argument. The only court to express a contrary view is the Seventh Circuit in *Merit Life*, and we

It is not surprising that accrual accounting should diverge from NAIC procedures. The two approaches have strikingly different purposes and different intended audiences. As one court of appeals explained, "there 'are several areas where differences exist between the accrual basis used for the annual statement and the general rules of accrual for tax purposes' because 'the emphasis of the annual statement has been on the solvency of the company.' " *Jefferson Standard Life Insurance Co.* v. *United States,* 408 F.2d 842, 849-850 (4th Cir. 1969) (quoting R. Denney and A. Rua, *Federal Income Taxation of Insurance Companies* at 9.3 (1961)), cert. denied, 396 U.S. 828 (1969); see also *Liberty Life Insurance Co.* v. *United States,* 594 F.2d 21, 25 (4th Cir. 1979). The approach to writing off expenditures, such as the ceding commissions here, presents a good example of the differences between annual statement and tax accounting. It is consistent with a conservative approach to measuring an insurance company's resources—in line with preserving an institution's solvency—to write down income immediately by the amount paid by an indemnity reinsurer to acquire future income from a block of policies. But that same accounting philosophy skews the proper measurement of taxable in-

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submit that that court erred from the outset when it accepted the Tax Court's premise that indemnity reinsurance is comparable to direct insurance. Indeed, petitioner's argument that NAIC accounting procedures are controlling ultimately proves too much, for the NAIC procedures on which it relies appear equally to require a first-year write off, not only of ceding commissions paid in indemnity reinsurance, but also of those paid in assumption reinsurance as well (contrary to accrual accounting principles, Treas. Reg. § 1.817-4(d)(2)(ii)(B), and the settled authority (see note 12, *supra*)). See G.K. Patterson, *Reinsurance,* at 539 (R. Strain 1980); C.M. Beardsley, *Life Company Annual Statement Handbook,* at 4-1 (1974); *Oxford Life Ins. Co.* v. *United States,* 574 F. Supp. 1417, 1421 (D. Ariz. 1983), aff'd, 790 F.2d 1370 (9th Cir. 1986).

come by creating an imaginary present day loss from a transaction fully expected to produce future gains. Compare *United States* v. *General Dynamics Corp.,* 481 U.S. 239, 246 (1987) (financial accounting); *Thor Power Tool Co.* v. *Commissioner,* 439 U.S. 522, 538-544 (1979) (same). Thus, Congress understandably protected federal revenue by prohibiting the use of the NAIC methodology when it transgresses standard accrual accounting rules.

Indeed, industry accounting guides, other than the NAIC, recognize that indemnity reinsurers are buying a future stream of income from a block of policies, which requires the ceding commission to be capitalized and amortized. *The Industry Audit Guide of Stock Life Insurance Companies* (1972), prepared by the Committee on Insurance Accounting and Auditing of the American Institute of Certified Public Accountants, has recognized (at 92) that a ceding commission is in the nature of an "acquisition expense" for the purchase of business. Thus, the guide states:

> Under generally accepted accounting principles for special reinsurance agreements which are constructed so as the shift a significant part of the economic risk from one company to another * * * [t]he net cost to the assuming company should be treated as an acquisition expense to be amortized over the premium-paying period on a basis consistent with that used for acquisition expenses of other business.

Ibid. The generally accepted accounting principles reflected in the guide provide a clear indication that accrual accounting methods do not permit the current deduction of ceding commissions, even for ordinary financial statement purposes. Thus, petitioner's contention that this Court must recognize a current deduction for ceding

commissions to "give effect to the NAIC accounting" requirements (Br. 30) has no application to this context.

* * *

This case clearly illustrates the abuses that petitioner's position would invite in the taxation of reinsurance transactions. As petitioner's expert witness acknowledged, profitable insurance companies could utilize such reinsurance agreements each year to defer taxation indefinitely on *all* of their underwriting gains (Tr. 58). Indeed, the combination of coinsurance and modified coinsurance agreements used here to create "wash" transactions with little cash changing hands would enable petitioner to manufacture such "tax losses" without incurring any substantial net out-of-pocket cash outlays at all. Thus, the only limitations on a life insurance company's ability to offset all of its underwriting gains in this manner would be the amount of its surplus and the willingness of potential ceding companies to share their policies' future profits at a commensurate present-day price. In short, the *more* such potentially profitable transactions an indemnity reinsurer enters, the *less* its tax liability would become. Nothing in the Code authorizes what would amount to a reinsurance shell game, in which the premium income from indemnity reinsurance would continually be advanced from year to year, but never be recognized for purposes of federal income taxation.

Amici American Council of Life Insurance, et al. suggest (Br. 23-26) that denying an indemnity reinsurer the benefit of an immediate write-off of ceding commissions will "disadvantage" direct writers that depend on reinsurance to grow. That argument stands the issue in this case on its head. Treating indemnity reinsurers consistently with all other taxpayers who incur present outlays for

future benefits cannot fairly be characterized as penalizing the reinsurance industry or its clients. As in the case of assumption reinsurance, the effect of requiring the reinsurer to capitalize and amortize these ceding commissions over the projected life of the reinsurance agreement is simply to match the annual revenues generated under the agreement against the cost of acquiring the right to such revenues. It is not punitive to deny the reinsurer the benefit of the huge initial "tax losses" claimed in such cases where, in fact, the reinsurer fully expects to enjoy a long-term profit on the transactions, and, indeed, may not even be required to disburse any substantial funds of its own in acquiring such rights.[30]

In sum, the court of appeals was correct in recognizing that ceding commissions in indemnity reinsurance are inherently capital outlays, and that neither Section 809(c)(1)

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[30] Amici predict dire consequences for the industry and consumers if this Court were to rule for the IRS (Br. 25). Amici raise the specter that reinsurers would not be willing to pay such large ceding commissions as they do now to enter indemnity reinsurance agreements unless they can enjoy similarly large tax benefits, and that smaller or newer insurance companies, which have a greater need for reinsurance, would thus have to charge the public higher premiums to make up for this lost income. In the first place, that speculative argument rests on a shaky empirical premise, since even smaller and newer companies operate in a competitive environment and cannot simply raise their premiums at will. At bottom, however, amici's policy argument only recognizes that the direct impact of this case falls on the *re*insurance industry, and that the consequences for other parties are simply guesswork. Indeed, it seems far more likely that the only significant impact of a decision affirming the judgment below (other than on tax revenues) would be to discourage reinsurance transactions when the dominant purpose is simply tax avoidance, rather than an independent business reason. In any event, amici's contentions concerning desirable policy should be presented to Congress, rather than to this Court.

nor any other provision of the Code allows them to be currently deducted. Under well established tax principles, the amount paid to acquire the right to future income from reinsured policies in indemnity reinsurance must be capitalized and amortized over the period of indemnification.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

The Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the years 1975 and 1976, provided in relevant part:

§ 809 **In General.** –

* * * * *

(c) **Gross Amount.** – For purposes of subsections (b)(1) and (2), the following items shall be taken into account:

(1) **Premiums.** – The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

* * * * *

(d) **Deductions.** – For purposes of subsections (b)(1) and (2). There shall be allowed the following deductions:

(7) **Assumption by another person of liabilities under insurance, etc., contracts.** – The consideration (other than consideration arising out of reinsurance ceded) in respect of the

assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

* * * * *

(12) **Other deductions.**—Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

* * * * *

§ 818 **Accounting Provisions.**

(a) **Method of Accounting.**—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.809-4 **Gross amount.**

(a)(ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. For the treatment of amounts which do not meet the requirements of return premiums, see Section 811 (relating to dividends to policyholders).

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